TEACHERS' RETIREMENT BOARD

INVESTMENT COMMITTEE

SUBJECT: Real Estate – Real Estate Benchmark Discussion ITEM NUMBER: 10

ATTACHMENT(S): 1

ACTION: ____ DATE OF MEETING: December 4, 2002

INFORMATION: X PRESENTER(S): Mike DiRé and Nori Gerardo Lietz

---

Executive Summary

Part of the Annual Business Plan was for the Investment Committee's real estate consultant, Pension Consulting Alliance Inc. (PCA), to review the benchmark for real estate. The real estate investment portfolio and strategy has undergone significant changes since the current benchmark, the NCREIF Index, was put in place. Included in these changes are:

1) A change in leverage policy
2) A larger focus on higher risk/return assets
3) More investments in structured relationships (i.e. funds and joint ventures) with pay-for-performance incentives
4) A change in the staff compensation to include a pay for performance incentive bonus

Staff has requested that PCA review the current NCREIF benchmark and, taking into account the above, discuss with the Investment Committee the following:

1) What are the available benchmarks for real estate?
2) What are the pros and cons of each benchmark?
3) What is the most appropriate benchmark?

Attached is PCA's discussion of this issue.

M E M O R A N D U M

DATE: November 19, 2002

TO: Investment Committee
California State Teachers' Retirement System

FROM: Nori Gerardo Lietz

CC: Christopher Ailman
Mike DiRe

RE: Real Estate Benchmark

We have had a series of conversations with CalSTRS real estate staff regarding the question of what the appropriate benchmark for the real estate portfolio should be in light of the fact that the real estate portfolio strategy and composition have changed dramatically from a few years ago.

The current real estate benchmark that CalSTRS uses is the NCREIF Property Index, which reflects the performance of 3,956 institutionally owned properties with an unleveraged market capitalization of $124.9 billion as of June 30, 2002. The NCREIF Index is an imperfect benchmark given that (i) the assets in the index are not priced daily; (ii) the index is based upon appraised values, which lag the actual market, and (iii) the managers decide which data to contribute to the industry association. That being said, the NCREIF Index is the best available benchmark against which to compare the performance of a “core”, unleveraged real estate portfolio. The NCREIF Index is a reasonable barometer regarding the performance of institutionally owned assets of US based pension funds.

CalSTRS has implemented a series of structural changes to its real estate portfolio, the net result of which should be to enhance returns. These changes include adopting a leverage policy and making a number of investments in the moderate and high risk components of the real estate portfolio. These changes increase CalSTRS' expected return for the real estate portfolio, but they also increase the risk profile as well.

Therefore, to measure the risk-adjusted performance of the real estate portfolio, we think adjustments may need to be made to the benchmark to quantify whether CalSTRS is receiving an appropriate level of return commensurate with the level of risk assumed in the various strategies now employed in the portfolio.

There are a number of issues that need to be addressed, such as:

- How much should the leverage employed increase the expected return of the composite portfolio over the unleveraged NCREIF Index?

- What should the return premium be for the newer investments, such as joint ventures and high risk commingled funds, over the NCREIF Index?

- How do we separate the effectiveness of Staff decisions, such as leverage at the portfolio level, from manager decisions at the asset level? How should this factor into the Staff's compensation arrangements?

- How do we integrate commingled funds and joint ventures, which are typically measured on an internal rate of return ("IRR") basis as opposed to a time weighted rate of return ("TWR") basis, which is used for the low risk portfolio?

- Should we leave the composite benchmark alone but create instead custom benchmarks for each manager based upon the risks inherent in their strategy? There are already established custom benchmarks for the Moderate and High Risk Portfolios, NCREIF + 200 b.p. and NCREIF + 500 b.p., respectively.

In short, there are several questions that need to be addressed so that the Investment Committee can continually evaluate and monitor the performance of the real estate portfolio. We recommend that we analyze this further and report back to the Investment Committee in March or April 2003 with any proposed modifications to the current policy benchmark. We will also review the current reporting format to ensure that it accurately addresses the issues identified above.